Melissa E. Newman
Vice President
Federal Regulatory Affairs
1099 New York Avenue NW, Suite 250
Washington, DC 20001
202.429.3120

Ex Parte Submission for the Record

September 9, 2016

Ms. Marlene H. Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

Re: *Investigation of Certain Price Cap Local Exchange Carrier Business Data Services Tariff Pricing Plans*, WC Docket No. 15-247; *Special Access for Price Cap Local Exchange Carriers; AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, WC Docket No. 05-25, RM-10593

Dear Ms. Dortch:

CenturyLink and the other Mid-Size ILECs recently submitted a detailed letter showing that the August 9, 2016 Verizon-INCOMPAS proposal is badly flawed.[1] In this letter, CenturyLink responds to INCOMPAS's attempt to prop up one of the most extreme and unjustified aspects of that proposal. Specifically, Verizon and INCOMPAS propose to slash rates for price cap LECs' DS1 and DS3 services by approximately 24% in the first two years of the plan,[2] based on the unsupported assumption that the cost of providing these aging services has declined precipitously over the past decade. In fact, CenturyLink's cost to provide legacy TDM services such as DS1s and DS3s has increased over time even as the regulated price of those services has steadily declined in real terms.[3] We submit this letter to rebut INCOMPAS's

[1] *See* Letter from Russell P. Hanser, Counsel to CenturyLink, Inc., Frontier Communications Corporation, FairPoint Communications, Inc., and Consolidated Communications ("Mid-Size ILECs"), to Marlene H. Dortch, FCC, WC Docket Nos. 16-143, 05-25, RM-10593 (Aug. 29, 2016).

[2] *See also* Letter from Kathleen Grillo, Verizon, and Chip Pickering, INCOMPAS, to Marlene H. Dortch, FCC, WC Docket Nos. 16-143, 05-25, RM-10593, at 1 (Aug. 9, 2016) ("Verizon-INCOMPAS proposal").

recent suggestions that CenturyLink's cost analysis in the August 12 Letter is "unreliable," inconsistent with CenturyLink's public statements, or contradicted by its earning statements.[4]

CenturyLink's cost analysis is reliable. INCOMPAS asserts that the cost analysis in CenturyLink's August 12 letter is "unreliable" because it purportedly depends on "opaque, results-driven accounting."[5] In fact, that analysis uses data that were compiled and reported in the different forms required by this Commission and the Securities and Exchange Commission (SEC). In addition to the results of this analysis, CenturyLink included the numbers used to calculate the operating expense per access line and operating expense per business data service (BDS)[6] circuit for each year in question.[7] These figures naturally do not correspond directly to those found in CenturyLink's filings with the SEC (such as 10-K reports) because the latter include results from CenturyLink's out-of-region domestic and international operations, as well as other services that do not use CenturyLink's in-region telecommunications networks, such as cloud and data hosting services. Such services are not relevant to a discussion of the rates and costs of in-region BDS services. INCOMPAS also suggests that the use of CenturyLink "BDS circuits" or "access lines" in the denominator for these calculations "artificially" raises the per-circuit cost and misleadingly implies that demand for CenturyLink's BDS is falling. INCOMPAS is mistaken. Demand for CenturyLink's BDS did in fact decline over the relevant period, whether measured as number of circuits or revenues.[8] Thus, while it may be true that "BDS demand is actually increasing" for INCOMPAS' CLEC members,[9] that is not the case for

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[3] *See* Letter from Melissa Newman, CenturyLink, to Marlene H. Dortch, FCC, WC Docket Nos. 16-143, 05-25, RM-10593 (Aug. 12, 2016) (CenturyLink August 12 Letter). From 2007 to 2015, CenturyLink's ILEC operating expense per access line increased by more than 50%, and its operating expense per BDS circuit increased from 2011 to 2015 as well. *Id.* at 2-3.

[4] *See* Letter from Karen Reidy, INCOMPAS, to Marlene H. Dortch, FCC, WC Docket Nos. 16-143, 05-25, RM-10593, at 1 (Aug. 24, 2016) (INCOMPAS August 24 Letter).

[5] *Id.* at 2.

[6] In this letter, the term "business data service" is defined in the same way it was defined in the FNPRM.

[7] *See* August 12 Letter, Attachments A and B.

[8] *See* CenturyLink August 12 Letter, Attachments A and B. In addition, as reflected in CenturyLink's quarterly and annual filings with the SEC, special access and private line (legacy TDM services) revenue declined 32.3% or $762 million from 2012 through 2015. By contrast, Ethernet, DWDM and Wave services (which are the growing BDS segments) increased $457 million from 2012 through 2015. CenturyLink's net loss of BDS revenue during this time period, therefore, was $305 million (or 40%) between 2012 through 2015.

[9] *See* INCOMPAS August 24 Letter at 3.

CenturyLink. Intense competition in the BDS marketplace has increasingly led CenturyLink's DS1 and DS3 customers to migrate to packet-based BDS offered by *other* providers in addition to (and frequently more often than) migrating to packet-based BDS services offered by CenturyLink. And it is beyond question that demand for CenturyLink's access lines has declined dramatically during the past decade, as POTS subscribers have moved to cable telephony and other wireline alternatives or "cut the cord" entirely, steadily reducing the revenues available to recover the high fixed and common costs inherent in CenturyLink's TDM network.[10] Given these trends, it should not be surprising that CenturyLink's average cost of providing service on its in-region telecommunications network has increased since 2005.

CenturyLink's increasing cost of providing BDS is consistent with its public statements. INCOMPAS also asserts that CenturyLink's public statements are inconsistent with its analysis showing that its BDS costs are increasing. That is incorrect. INCOMPAS focuses on statements by CenturyLink's Chief Financial Officer, Stewart Ewing, in a May 2016 earnings call. Mr. Ewing explained that substantial reductions to BDS rates of the type proposed by INCOMPAS and Verizon would "hinder further investment in broadband, especially in rural areas where it's tough to make the investment work anyway."[11] In response to a further question about CenturyLink's "net exposure" between special access revenue and network costs, Mr. Ewing explained that the network cost for these services is "mostly in the investment that was required to build the service out," with relatively minimal ongoing maintenance cost.[12] Thus, he added, these services are "high margin" from a short-run perspective once those large up-front investments are made.[13]

INCOMPAS contends that this "high margin" statement somehow contradicts the cost analysis in CenturyLink's August 12 letter, but it does not: as Mr. Ewing made clear, these

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[10] *See In the Matter of Petition of USTelecom for Forbearance Pursuant to 47 U.S.C. § 160(c) from Enforcement of Obsolete ILEC Legacy Regulations That Inhibit Deployment of Next-Generation Networks; Lifeline and Link Up Reform and Modernization; Connect America Fund*, 31 FCC Rcd 6157, 6161 ¶ 6 (2015) ("almost 75 percent of U.S. residential customers (approximately 88 million households) no longer receive telephone service over traditional copper facilities."). INCOMPAS's suggestion that "it is still good for business" when subscribers cancel CenturyLink access lines bears no relationship to reality. *See* INCOMPAS August 24 Letter at 3 n.8. When a CenturyLink telephony subscriber switches to a competing cable provider, for example, it typically takes all of its business to that provider. And, even if a customer retains its DSL connection with CenturyLink when it disconnects its voice service, CenturyLink receives no additional revenue to offset the lost access line revenue.

[11] CenturyLink, *FQ1 2016 Earnings Call Transcripts* at 11 (May 4, 2016).

[12] *See id.* at 11.

[13] *See id.* In accounting terms, it is clear that Mr. Ewing was referring to "gross margins" and not net income.

services are "high margin" only if one ignores the substantial fixed costs of capital investment. As the Commission has long observed, telecommunications networks are characterized by high fixed costs and low marginal costs.[14] Once a carrier has made the considerable capital investments (fixed costs) needed to build out its local network to particular locations, the marginal cost of providing each incremental unit of service at those locations is small by comparison. But a rational carrier would not make such capital investments to begin with if it were denied the opportunity to recover its total costs over time, including its high fixed costs.

As a matter of arithmetic, therefore, any carrier—ILEC or CLEC—must charge average prices that substantially exceed its short-run marginal costs.[15] Mr. Ewing's comment simply restates that basic economic reality: business data services are "high margin" from a *short-run* perspective once a carrier has already made the underlying "investment … required to build the service out." In contrast, INCOMPAS's proposed special access rules would—in Mr. Ewing's words—"just hinder further investment in broadband" by depriving a carrier of the opportunity to recover its substantial fixed costs in addition to its marginal costs. Not only would that carrier have less cash to make new capital investments, but those investments would no longer make economic sense.

INCOMPAS fares no better when it relies on Mr. Ewing's statements in a subsequent earnings call. On that call, Mr. Ewing noted that CenturyLink's legacy revenues in the business segment had fallen 7.4% from second quarter 2015, "due primarily to a continuing decline in voice and low bandwidth data services."[16] While CenturyLink's strategic revenues for the business segment increased 5% compared to second quarter 2015, "driven primarily by the continued growth in high-bandwidth data services, partially offset by the decline in hosting

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[14] *See*, *e.g.*, *FNPRM* ¶ 357 ("the marginal cost of additional output is low in telecommunications"); Initial Decision, *Western Union Tel. Co.*, 25 F.C.C. 535, ¶ 171 (1958) ("high fixed costs are a characteristic of public utilities").

[15] *See, e.g.*, First Report & Order, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 11 FCC Rcd 15499, ¶ 692 (1996) (adopting a "'long run' approach ensur[ing] that rates recover not only the operating costs that vary in the short run, but also fixed investment costs that, while not variable in the short term, are necessary inputs"); William J. Baumol, *The Free-Market Innovation Machine: Analyzing the Growth Miracle of Capitalism* 167 (2002) ("although … prices exceed marginal costs" in industries with substantial fixed costs, "they are patently not evidence of the absence of effective competition"); *see also* W. Kip Viscusi, et al., *Economics of Regulation and Antitrust* 6-7 (3d ed. 2000) (discussing relationship of average costs to marginal costs in capital-intensive industries).

[16] CenturyLink, *FQ2 2016 Earnings Call Transcripts* at 7 (Aug. 3, 2016), available at http://ir.centurylink.com/Cache/1001212835.PDF?Y=&O=PDF&D=&fid=1001212835&T=&iid=4057179.

revenues,"[17] that trend does not reflect overall growth in CenturyLink's BDS. For some time, CenturyLink has experienced declining usage on its in-region and legacy TDM networks while endeavoring to offset those declines through growth in Ethernet data services which have not been able to offset the declines in TDM services. The company has also attempted to grow out-of-region (competitive), fiber-based and edge networks and services. As noted in the presentation for the earnings call, "[b]eginning second quarter 2016, private line (including special access) revenues were reclassified from strategic services to legacy services," and "[a]ll historical periods have been restated to reflect this change."[18] Thus, Mr. Ewing's statements on this earnings call tell the same story as in CenturyLink's August 12 letter: CenturyLink's ILEC operating revenues are declining, while its per-circuit costs climb.

CenturyLink's cost analysis is not contradicted by its earnings statements. INCOMPAS also claims that CenturyLink's earning results do not support the cost analysis in CenturyLink's August 12 letter. In particular, INCOMPAS appears to suggest that if CenturyLink's BDS costs were rising, it would have a duty to disclose these increasing costs in its SEC financial reports.[19] That is not the case. CenturyLink has properly disclosed the declining nature of its legacy telecommunications business, including TDM services such as DS1 and DS3 services. It has also noted to potential investors that it is incurring lower margins as its legacy revenues are partially offset by revenues for strategic services.[20] Hence, CenturyLink's earning statements are consistent with CenturyLink's cost analysis in the August 12 letter.[21]

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[17] *Id.*

[18] *CenturyLink 2nd Quarter 2016 Earnings Results*, available at https://www.snl.com/Cache/1001212708.PDF?Y=&O=PDF&D=&fid=1001212708&T=&iid=4057179 (Aug. 3, 2016).

[19] *See* INCOMPAS August 24 Letter at 4.

[20] *E.g.*, CenturyLink, *Form 10-K*, 2015, at 34.

[21] INCOMPAS claims that CenturyLink's SEC reports show that the company's revenues and margins increased on a per-subscriber basis between 2005 and 2015. *Supra,* n.19. Once again, this line of argument is not relevant to the question of the rates and costs for in-region BDS. CenturyLink has transitioned over the past decade from being a relatively small and predominately rural, high-cost incumbent local exchange carrier to a much larger and more diversified national and international communications company offering a wide range of voice, video, data, cloud, hosting and other services to residential, business, enterprise, and government customers all over the globe. Naturally, deregulated revenues have increased during this time, but none of this is relevant to this proceeding because such results have not altered the increasing costs of providing BDS, particularly DS1 and DS3 services. INCOMPAS' reference to purported increases in CenturyLink's shareholder payouts are similarly irrelevant as such

There is no justification in the record for the steep rate cuts sought by INCOMPAS and Verizon. As in the Verizon-INCOMPAS proposal, INCOMPAS once again provides no evidence to support the sweeping rate cuts it seeks and instead relies on vague and unsupported claims that current BDS rates fail to account for productivity gains over the past decade.[22] In fact, there is no evidence of any such productivity gains. As the Mid-Size ILECs have noted, "the costs for inputs used in the provision of TDM BDS offerings are either holding constant or rising, utilization of these facilities is falling (limiting ILECs' abilities to amortize costs over many customers relying on shared facilities), and the rates frozen by the CALLS plan were themselves below competitive levels."[23]

When viewed appropriately, the KLEMS data actually call for an *increase* in rates for these services. Analyses purporting to justify significant self-serving rate cuts "are either based on cost models not designed to measure changes in productivity or rely on European data designed to measure value added rather than gross output; neither data set is appropriate for use in measuring alleged efficiency gains in the American BDS marketplace."[24] Thus, there is no credible data in the record to support a reduction in current DSn rates (or, for that matter, any indirect reduction of Ethernet rates through TDM-based benchmarking). The substantial rate cuts sought by INCOMPAS and Verizon therefore would be arbitrary and capricious.

Pursuant to section 1.1206(b) of the Commission's rules, this letter is being filed in the above-referenced dockets. Please contact the undersigned with any questions.

Sincerely,

/s/ Melissa Newman

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dividend payments are the cost of borrowing capital from equity shareholders and, thus, are properly viewed as comparable to interest expense.

[22] *See, e.g.*, INCOMPAS August 24 Letter at 1-2 ("there should be a one-time adjustment to BDS rates under price caps because the FCC has not accounted for productivity gains since the expiration of the CALLs plan[.]"); *id.* at 2 (the Commission "should find that the proposed rate reduction is necessary to correct failure to make productivity adjustments to the rates of TDM-based services for more than ten years and to restore effective price cap regulation for TDM-based BDS offerings."); *id.* at 4 ("The data collection and the record evidence in this proceeding confirm that ILECs do not face meaningful, effective competition in the provision of BDS. As a result, the Commission must act to bring down artificially inflated BDS prices.").

[23] *See* Mid-Size ILECs August 29 Letter at 3.

[24] *Id.* at 3-4.